124

No. 08-916

In The
Supreme Court of the United States

VFJ VENTURES, INC., F/K/A VF JEANSWEAR, INC.,

Petitioner,

v.

G. THOMAS SURTEES, IN HIS OFFICIAL CAPACITY AS COMMISSIONER OF THE DEPARTMENT OF REVENUE FOR THE STATE OF ALABAMA, AND THE ALABAMA DEPARTMENT OF REVENUE,

Respondents.

On Petition For A Writ Of Certiorari To The Supreme Court Of Alabama

BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

Alabama's "add-back" statute requires corporations to "add back" to income any payments made to a related corporate member for intangibles expenses such as royalties or interest, if those payments were deducted from income. The statute provides an exception "to the extent . . . that the corresponding item of income was . . . subject to a tax based on . . . the related member's net income in Alabama or any other state. . . ." The questions presented are:

1. Whether the court below correctly held that there was no Commerce Clause discrimination where the subject-to-tax exception does not favor in-state economic interests.

2. Whether the court below correctly held that the unitary business income of VFJ was fairly apportioned to Alabama using Alabama's standard three-factor apportionment formula.

TABLE OF CONTENTS

Page

QUESTIONS PRESENTED i

TABLE OF AUTHORITIES v

STATEMENT OF THE CASE 1

A. Background of the related intangibles holding company device and the enactment of Alabama's add-back statute 1

B. VFJ and its related Delaware intangibles holding companies 4

C. The disallowance of VFJ's deduction for payments to its related intangibles holding companies, and the proceedings below 7

REASONS FOR DENYING THE PETITION 11

I. THERE IS NO CONFLICT BETWEEN THE DECISION BELOW AND THIS COURT'S PRECEDENTS 12

A. The decision below properly applied this Court's Commerce Clause precedents in finding that the facially-neutral subject-to-tax exception does not have the effect of favoring in-state economic activity and therefore does not discriminate against interstate commerce 12

TABLE OF CONTENTS – Continued

Page

B. The decision below properly applied this Court's fair-apportionment precedents in finding that the application of Alabama's standard three-factor apportionment methodology ensures that the add-back statute does not result in an unconstitutional apportionment of income to the state 19

II. IT WOULD BE WOEFULLY PREMATURE TO REVIEW THE ISSUES RAISED BY VFJ 27

A. The decision below is the only appellate decision in the nation addressing such statutes 27

B. The issues now raised by VFJ were severely underdeveloped by VFJ below. Therefore, this case does not constitute a suitable vehicle for discretionary review 28

III. VFJ'S PETITION DOES NOT PRESENT QUESTIONS OF PUBLIC OR "SURPASSING" IMPORTANCE 32

A. There is no "cloud of uncertainty" in the states' administration of add-back statutes 32

B. A reversal in this case would not provide relief to VFJ or to others similarly situated 32

TABLE OF CONTENTS – Continued

Page

C. VFJ's concern for state coffers is unavailing 34

CONCLUSION 35

TABLE OF AUTHORITIES

Page

CASES:

Chemical Waste Mgmt., Inc. v. Hunt, 504 U.S. 334 (1992) 13

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977) 9, 13, 16, 21

Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983) 20, 22, 24, 29

Ex Parte VFJ Ventures, Inc., ___ So.2d ___, 2008 WL 4277998 (Ala. 2008) 11

Fulton Corp. v. Faulkner, 516 U.S. 325 (1996) 17, 18

Geoffrey, Inc. v. South Carolina Dep't of Revenue and Taxation, 437 S.E.2d 13 (S.Car. 1993), *cert. denied*, 114 S.Ct. 550 (1993) 22

Healy v. Beer Inst., Inc., 491 U.S. 324 (1989) 25

Henneford v. Silas Mason Co., 300 U.S. 577 (1937) 18, 24, 25, 26

Hunt-Wesson, Inc. v. Franchise Tax Bd., 528 U.S. 458 (2000) 19, 21, 22, 23

King v. Campbell, 988 So.2d 969 (Ala. 2007) 33

KMart Corp. v. Taxation & Revenue Dep't, 131 P.3d 22 (N.M. 2005) 2

Lanco, Inc. v. Director, Div'n of Tax'n, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S.Ct. 2974 (2007) 3, 22

Norfolk & W. Ry. Co. v. Missouri State Tax Comm'n, 390 U.S. 317 (1968) 20, 23

TABLE OF AUTHORITIES – Continued

Page

Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175 (1995) 18, 23, 26, 29

Oregon Waste Systems, Inc. v. Department of Environmental Quality, 511 U.S. 93 (1994) 13

South Central Bell Telephone Co. v. Alabama, 526 U.S. 160 (1999) 13

Surtees v. VFJ Ventures, Inc., ___ So.2d ___, 2008 WL 344118 (Ala. Civ. App. 2008) 9

West Lynn Creamery, Inc. v. Healy, 512 U.S. 186 (1994) 13

CONSTITUTION, STATUTES, AND RULE:

U.S. Const. art. I, § 8, cl. 3 ..... 10, 11, 12, 13, 17

Acts of Alabama 2001-1088, Section 9 33

Ala. Code § 1-1-16 33

Ala. Code § 40-2A-7(b)(5)a 33, 34

Ala. Code § 40-2A-7(b)(5)b 33, 34

Ala. Code § 40-2A-7(b)(5)b.2 34

Ala. Code § 40-2A-9(g) 34

Ala. Code § 40-18-31(a) 15

Ala. Code § 40-18-35(b) ..... *passim*

Ala. Code § 40-18-35(b)(1) 4, 10, 14

Ala. Code § 40-18-35(b)(2) 9

TABLE OF AUTHORITIES – Continued

Page

Del. Code Ann. Tit. 30, § 6407 26

Sup. Ct. R. 10 34

TREATISES:

J. Hellerstein & W. Hellerstein, *State Taxation* ¶ 9.20[3][j] (2009) 1, 2

MISCELLANEOUS:

All States Tax Guide (RIA) ¶ 236-A (2009) 26

All States Tax Guide (RIA) ¶ 5485 (2009) 25

Donald M. Griswold, *Addbacks Add Nothing to the Debate*, 48 State Tax Notes 1073 (June 30, 2008) 31

Glenn R. Simpson, "Diminishing Returns: A Tax Maneuver in Delaware Puts Squeeze on States," *Wall St. J.*, Aug. 9, 2002 at A1 2

J. Alexander Meleney, *Framing the Issues: Historical Context, Current Debate, and Relevant Income and Nonincome Tax Considerations*, 11 State & Local Tax Lawyer 1 (2006), p.7 2

Michael Mazerov, *Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States* 7-8 (Center on Budget & Policy Priorities 2002), *available at* www.cbpp.org/4-9-02sfp.pdf 2

TABLE OF AUTHORITIES – Continued

Page

Thomas H. Steele & Pilar M. Sansone, *Surveying Constitutional Theories for Challenges to the Addback Statutes*, 35 State Tax Notes 613 (Feb. 28, 2005).....31

STATEMENT OF THE CASE

A. BACKGROUND OF THE RELATED INTANGIBLES HOLDING COMPANY DEVICE AND THE ENACTMENT OF ALABAMA'S ADD-BACK STATUTE

Alabama's add-back statute, Ala. Code § 40-18-35(b), was enacted in 2001 as a response to a widely-used state corporate tax avoidance strategy. Starting in the 1980s, and increasingly in the 1990s, many large American businesses established intangibles holding company subsidiaries as a device to minimize their state tax obligations to those states, such as Alabama, that apportion taxpayers' income on a separate-entity basis, as opposed to a combined-reporting basis. As the leading state tax treatise explains, "One of the standard tax-planning devices corporations employ to reduce taxable income in states where they conduct their operations is to transfer their trademarks or trade names to an intangibles holding company (IHC) and license back the trademarks or trade names for a royalty." J. Hellerstein & W. Hellerstein, *State Taxation* ¶ 9.20[3][j] (2009).

By deducting the royalty expenses from the income of the operating company, related corporations can substantially reduce, or even eliminate, the operating company's net income that is subject to apportionment and taxation in the (separate-entity accounting) states where the company operates. Instead, the royalty payments siphon off the income to the intangibles holding company, which is located

in a jurisdiction, like Delaware or Nevada, where such income is not subjected to taxation. The effect is to shelter a very large portion of a business's net income from state taxation, by attributing the income to a state where the business locates only a very small toehold of its actual personnel and physical assets, in what the Hellerstein treatise describes as "transparent efforts to 'game' the system." *Id.*

The intangibles holding company device has been aggressively marketed to businesses by large accounting firms and by Delaware financial and consulting firms, which assist companies in establishing intangibles holding companies and in ensuring that they maintain a sufficient presence in Delaware to rebut allegations of sham transactions. *See, e.g.*, Glenn R. Simpson, "Diminishing Returns: A Tax Maneuver in Delaware Puts Squeeze on States," *Wall St. J.*, Aug. 9, 2002 at A1; *KMart Corp. v. Taxation & Revenue Dep't*, 131 P.3d 22, 23-24 (N.M. 2005). The result has been a rapid spread of the use of this stratagem by large corporations, and, consequently, a significant erosion of state corporate-tax revenues. By the late 1990s, new intangibles holding companies were being formed in Delaware at a rate of 600 to 800 per year. Michael Mazerov, *Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States* 7-8 (Center on Budget & Policy Priorities 2002), *available at* www.cbpp.org/4-9-02sfp.pdf. *See* J. Alexander Meleney, *Framing the Issues: Historical Context, Current Debate, and Relevant Income and Nonincome Tax Considerations*, 11

State & Local Tax Lawyer 1, 7 (2006) (describing "the ubiquitous intangible property holding company" as "the most obvious example" of state tax shelters).

The states have adopted a variety of measures in order to stanch the loss of corporate tax revenues from the creation of intangibles holding companies. For example, several states have succeeded in subjecting the holding companies themselves to the state's corporate income tax, on the grounds that, by licensing their intangibles for use in the state, they were engaging in business activities in the state and, therefore, were subject to the state's tax. *See, e.g., Lanco, Inc. v. Director, Div'n of Tax'n*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S.Ct. 2974 (2007).

However, the most common approach is the path chosen by the Alabama legislature – the enactment of an "add-back" statute, which disallows the deductions that lie at the heart of the intangibles holding company device.[1] The disallowance of royalty-expense deductions paid to a related corporation prevents the siphoning off of the business's operating income and allows that income to be apportioned and taxed based on where the business actually conducts its income-producing activities.

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[1] Add-back statutes have been enacted in the vast majority of states that employ separate-entity accounting and that are, therefore, susceptible to the tax-avoidance strategy. Pet. App. 12a n. 3.

The Alabama add-back statute, like those in other states, provides for several exceptions to the disallowance of related-party royalty-expense deductions, and, in the litigation below, the primary issues concerned the statutory interpretation of some of those exceptions. The instant Petition questions the constitutionality of one of those exceptions, which operates to allow the deduction of intangibles expenses paid to a related corporation "to the extent . . . that the corresponding item of income was . . . subject to a tax based on or measured by the related member's net income in Alabama or any other state." Ala. Code § 40-18-35(b)(1). This "subject-to-tax exception" has the effect of eliminating from the apportionable income of a company doing business in Alabama the amounts of any royalty expenses paid by that company to a related company, to the extent that those payments are subjected to state taxation (in Alabama or elsewhere) as part of the related company's income. Thus, the exception protects against any possibility that such income could be subjected to double taxation, once as part of the income of the operating company and again as part of the income of the related intangibles holding company.

B. VFJ AND ITS RELATED DELAWARE INTANGIBLES HOLDING COMPANIES

The top-tier parent of the Vanity Fair corporate family is VF Corporation, which is headquartered in Greensboro, North Carolina. VF Corporation is a parent holding company, and it directly or indirectly

owns the stock of its numerous worldwide subsidiaries, including the Petitioner – VFJ Ventures, Inc. ("VFJ").

VFJ manufactures, markets, and sells jeanswear – specifically, "Lee" and "Wrangler" jeans. In the State of Alabama during 2001, the year at issue, VFJ had a substantial presence that included two distribution facilities and a cutting facility.

During 2001, VFJ employed approximately 600 people in Alabama, which represented 15.36% of VFJ's entire payroll. Also in 2001, VFJ had gross sales of approximately $2.1 billion and federal taxable income of approximately $93.4 million. VFJ's Alabama sales during 2001 represented 11.15% of VFJ's gross sales for that year. Further, the cost of VFJ's tangible property used to produce business income during 2001 was a little more than one billion dollars, with more than $163 million worth of that tangible property being located in Alabama.

Starting in the 1980s, VF Corporation segregated the "Lee" and "Wrangler" trademarks into Delaware holding company subsidiaries that now bear those names, and those Delaware holding companies licensed the trademarks back to the VF operating companies for a royalty. In 2001, Lee and Wrangler were among twenty subsidiaries of VF Corporation that shared 3200 square feet of office space in a Delaware office building. Nineteen of those subsidiaries were intangibles holding companies. Of those twenty subsidiaries, only one – Lee – had employees,

and Lee had no more than eleven employees during 2001. The holding companies had no tangible assets or personnel anywhere other than Delaware.

The segregation of the trademarks into Delaware holding companies was coordinated with the licensing of those trademarks back to the operating companies, such as VFJ, which had the operating assets, personnel, and the experience and technical ability to design, manufacture and market the "Lee" and "Wrangler" jeans and other trademarked goods.

Segregating the trademarks into Delaware holding companies created significant state tax benefits for VFJ and for the VF corporate family. During 2001, VFJ paid $36,220,000 to Lee and $66,420,000 to Wrangler in royalties, and VFJ deducted the entire $102,640,000 amount. The effect was to leave VFJ – with its thousands of employees, billion dollars of capital assets, and $2 billion of sales – with substantially less net income than the combined net income of the two Delaware holding companies – with their one small shared office and handful of shared employees. The deduction for these royalties would have resulted in an Alabama tax savings for VFJ of nearly $1 million for 2001, but for the enactment of the add-back statute.

Meanwhile, the royalty income of the Delaware holding companies from the licensing of their trademarks was exempt from tax in Delaware. VF Corporation personnel tracked in detail the state tax savings of VFJ that were directly attributable to the

Lee and Wrangler Delaware holding company structure. That structure resulted in a state tax benefit, in the various states where VFJ operated, of $5,755,678 for the year 2000, and a state tax benefit of $6,115,488 for 2001.

C. THE DISALLOWANCE OF VFJ'S DEDUCTION FOR PAYMENTS TO ITS RELATED INTANGIBLES HOLDING COMPANIES, AND THE PROCEEDINGS BELOW

Pursuant to the add-back statute, the Alabama Department of Revenue[2] added back to VFJ's apportionable income the majority of VFJ's royalty payments to Lee and Wrangler. Pursuant to the subject-to-tax exception, however, the Department did not add back the amount of the royalty payments that had been subject to tax in North Carolina in the hands of Lee and Wrangler.[3] The Department then applied VFJ's apportionment ratio of 13.9299% to VFJ's apportionable income, including the royalty income that had been added back, using the apportionment ratio that had been provided by VFJ on its 2001 return. VFJ Trial Ex. 2. That ratio had been calculated by VFJ using Alabama's standard three-factor apportionment formula, reflecting the shares of

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[2] The Department and its Commissioner, as Respondents, are collectively referred to as "the Department."

[3] The exception allowed to VFJ totaled $3,660,464 ($1,042,520 relating to Lee and $2,617,944 relating to Wrangler). Clerk's Record 42.

VFJ's payroll, property, and sales that were located in Alabama.

VFJ misstates the preceding point of fact and law, by stating that "[t]he Department, however, required VFJ to add back the remainder of the royalty payments and assessed tax on that amount of additional income." Pet. 8. This is incorrect. Instead, the amount of royalty payments added back to VFJ's Alabama income was then *apportioned* to Alabama using VFJ's apportionment ratio of 13.9299%. Only that *apportioned* amount of income was taxed by Alabama.

VFJ appealed the tax assessment to circuit court. In Count I of its four-count Complaint, VFJ alleged that it should be entitled to a 100% subject-to-tax exception, solely because Lee and Wrangler reported the royalty income on their North Carolina returns prior to apportionment to that state. In Count II, VFJ alleged that add back would be unreasonable, because VFJ claimed that Lee and Wrangler had "business purpose" and "economic substance," and hence would be eligible for a statutory exception. In Count III, VFJ alleged that the subject-to-tax exception discriminated against interstate commerce. In Count IV, VFJ made non-specific claims as to the Due Process and Equal Protection clauses.

VFJ's primary issue in the litigation was its contention that the purpose of Alabama's add-back statute was to target payments to sham corporations.

Therefore, VFJ's trial evidence focused almost exclusively on VFJ's claim that Lee and Wrangler had business purpose and economic substance, and thus were not shams. Specifically, VFJ proposed that its related holding companies were factually distinct from the typical Delaware intangibles holding company device and, therefore, that VFJ should be granted the "unreasonableness" exception in Ala. Code § 40-18-35(b)(2). Pet. App. 79a. VFJ did not allege, or present any evidence suggesting, that the tax resulting from the application of the add-back statute was out of proportion to the activities of VFJ in Alabama in 2001.

The circuit court ruled in favor of VFJ as to the "unreasonableness" exception, interpreting the add-back statute to be limited to payments to sham corporations. That court did not address VFJ's constitutional claims. Pet. App. 65a-77a.

In a 78-page opinion, the Court of Civil Appeals, sitting en banc, unanimously reversed the circuit court. *Surtees v. VFJ Ventures, Inc.*, ___ So.2d ___, 2008 WL 344118 (Ala. Civ. App. 2008). In its brief to the Court of Civil Appeals, VFJ's argument concerning constitutionality was limited to four paragraphs, with only one paragraph mentioning fair apportionment and one paragraph mentioning discrimination. As to its discrimination claim, all VFJ argued was the following:

> Under *Complete Auto*, *supra*, a state tax may not discriminate against interstate

> commerce. Under the "subject-to-tax" exception, the taxpayer's (VFJ, in this case) Alabama corporate income tax burden depends upon where the recipient IMCO is located. The add-back statute thus requires differential tax treatment based merely on where the IMCOs are doing business; this is unconstitutional discrimination.

VFJ Br. 65 (citations omitted).

The appellate court, after reversing the trial court and finding in the Department's favor on the issues of statutory interpretation, analyzed and applied this Court's precedents concerning fair apportionment and Commerce-Clause[4] discrimination. Pet. App. 51a-53a, 56a-62a. The court noted that VFJ did not challenge the Department's add-back calculation, nor did VFJ present any evidence to show that the application of the add-back statute would result in VFJ paying an amount of tax to Alabama that was out of proportion to VFJ's activities in Alabama. Pet. App. 29a-30a, 40a, and 60a-61a.

As to VFJ's discrimination argument, the Court of Civil Appeals held that the subject-to-tax exception, which applies to royalty payments that were subject to tax "in Alabama or any other state of the United States," was facially neutral. Pet. App. 62a (quoting Ala. Code § 40-18-35(b)(1)). The court also stated that "the application of Alabama's add-back

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[4] U.S. Const. art. I, § 8, cl. 3.

statute does not benefit in-state corporations to the detriment of, or disproportionately to, out-of-state corporations." Pet. App. 62a. The court concluded by stating that "this court has addressed only those arguments VFJ has asserted in an effort to support the trial court's judgment in its favor. We decline to address any other arguments that might have been made regarding the alleged unconstitutionality of Alabama's add back statute." Pet. App. 63a-64a.

The Alabama Supreme Court, sitting en banc, unanimously affirmed the opinion of the Court of Civil Appeals, and adopted that opinion as its own. *Ex Parte VFJ Ventures, Inc.*, ___ So.2d ___, 2008 WL 4277998 (Ala. 2008).

REASONS FOR DENYING THE PETITION

A longstanding and well-established state law practice is to adjust a taxpayer's liability to reflect taxes paid to another state. States routinely provide tax credits in the sales and use tax area, as well as for income taxes paid to another state. Alabama's subject-to-tax exception to its add-back statute does the same thing and for the same reason, *i.e.* to protect taxpayers from multiple taxation. This Court has never held that such an adjustment violates the Due Process or Commerce Clauses, notwithstanding the fact that the amount of the adjustment depends upon the taxes paid to another state. Not surprisingly, then, the Alabama courts, applying settled doctrine, rejected

VFJ's constitutional arguments. Those decisions do not conflict with any decisions of this Court.

Of course, if state high courts had reached conflicting decisions about the constitutionality of state add-back statutes, this Court's review might be in order. To the contrary, however, even though twenty states have adopted add-back statutes, the decisions of the Alabama Court of Civil Appeals and Alabama Supreme Court are the first and only appellate decisions addressing the issue. Not a single other appellate court in the nation has decided whether a subject-to-tax exception violates the Due Process or Commerce Clauses, let alone reached a contrary conclusion. It is difficult to imagine an issue as to which this Court's intervention would be more premature.

I. THERE IS NO CONFLICT BETWEEN THE DECISION BELOW AND THIS COURT'S PRECEDENTS.

A. THE DECISION BELOW PROPERLY APPLIED THIS COURT'S COMMERCE CLAUSE PRECEDENTS IN FINDING THAT THE FACIALLY-NEUTRAL SUBJECT-TO-TAX EXCEPTION DOES NOT HAVE THE EFFECT OF FAVORING IN-STATE ECONOMIC ACTIVITY AND THEREFORE DOES NOT DISCRIMINATE AGAINST INTERSTATE COMMERCE.

VFJ asserts that the decision below conflicts with the decisions of this Court forbidding state tax provisions

that discriminate against interstate commerce. But, in fact, the Alabama courts correctly stated and applied the applicable constitutional provisions and upheld the subject-to-tax exception because it does not by its terms distinguish between in-state and out-of-state activity and because it does not have the effect of taxing "a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State." Pet. App. 61a (quoting *Chemical Waste Mgmt., Inc. v. Hunt*, 504 U.S. 334, 342 (1992)).

There is no conflict about the applicable Commerce Clause principles: In order to survive constitutional scrutiny, a state tax measure must "not discriminate against interstate commerce." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). "Discrimination," for these purposes, "simply means differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." *Oregon Waste Systems, Inc. v. Department of Environmental Quality*, 511 U.S. 93, 99 (1994). This Court has consistently struck down state tax measures that discriminated against interstate commerce either facially, *see, e.g., South Central Bell Telephone Co. v. Alabama*, 526 U.S. 160 (1999), or in their practical effects, *see, e.g., West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994).

In the proceedings below, VFJ placed primary emphasis as to its constitutional claims on the claim that the subject-to-tax exception was facially discriminatory. The Alabama courts properly rejected

this argument on the ground that the exception, by its express terms, applies equally whether the "related member's income is taxed 'in Alabama *or any other state*.'" Pet. App. 62a (emphasis in original) (quoting Ala. Code § 40-18-35(b)(1)).

In the instant Petition, VFJ appears to have abandoned the claim of facial discrimination in favor of an argument that the subject-to-tax exception has the impermissibly discriminatory effect of imposing a differential burden that favors transactions that take place entirely within Alabama over those that cross state lines into states (like Delaware) that choose not to tax income from intangibles. Pet. 14-16. As the courts below recognized, *see* Pet. App. 62a, if the subject-to-tax exception actually resulted in such differential treatment benefiting in-state activities or entities, it would indeed violate well-established constitutional norms.

But, in fact, VFJ's contention that it has such effects is simply mistaken, as VFJ's own witness at trial acknowledged, and as the courts below found. At trial, VF Corporation's vice president of tax, who testified that segregating the Wrangler intangibles into a Delaware holding company was his idea, acknowledged on direct examination that moving the Delaware holding companies to Alabama would cause VF to *lose* a tax benefit. Reporter's Transcript 345-46. Hence, it is not surprising that the Alabama courts found that "the application of Alabama's add-back statute does not benefit in-state corporations to the

detriment of, or disproportionately to, out-of-state corporations." Pet. App. 62a.

VFJ's claim of a discriminatory practical effect from the subject-to-tax exception hinges on its assertion that locating VFJ's intangibles holding companies in Alabama would result in a tax savings of over $1 million. Pet. 15. But, in reality, if VF Corporation (the parent) were to relocate the holding companies to Alabama, then those entities would become subject to Alabama tax on their income, which exceeded $100 million annually from VFJ alone. Thus, while VFJ is correct that such a move would reduce VFJ's Alabama tax liability by slightly over $1 million, it would do so only at the expense of increasing the holding companies' tax liabilities by approximately $6.5 million ($102 million of royalty income, minus deductions for its minimal operating costs, multiplied by Alabama's corporate income tax rate of 6.5%, *see* Ala. Code § 40-18-31(a)). In simple fact, under Alabama's add-back statute, relocating VFJ's related intangibles holding companies into Alabama would sharply increase, not reduce, the state tax liabilities of the business (and with no offsetting reduction in tax liabilities in other states, since the intangibles holding companies were not subject to Delaware tax when located there). The alleged discriminatory effect favoring in-state business activity simply does not exist.

More generally, as a matter of simple arithmetic, the Alabama statute will never provide a tax advantage for relocating a related intangibles holding company into Alabama (or into another state which

subjects income from intangibles to tax). If no exception is applicable, the add-back statute will restore any royalty payments to the operating company's income, but only an apportioned share of that income (reflecting the portion of the operating company's activity that is located in Alabama) will then be taxed by Alabama. By contrast, if the holding company is located in Alabama, then all of its income will be subject to Alabama tax.[5]

In short, the subject-to-tax exception, in its effort to avoid any risk of double taxation of income attributed to the intangibles holding company, has the effect of preserving for a business some of the tax advantage of locating the holding company in a tax-haven state. As a result, the add-back statute disfavors, rather than rewards, businesses that locate a portion of their holding-company activities in Alabama. When evaluated on the basis of its "practical effect," *see, e.g., Complete Auto*, 430 U.S. at 279, 287-89, the subject-to-tax exception offers absolutely none

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[5] If only a portion of the holding company's activity were relocated to Alabama, then only the applicable portion of its income would be subject to Alabama tax. But, by the same token, only the same portion of that income would be excluded from the apportionable income of the operating company pursuant to the subject-to-tax exception. So, the result would again be an increased tax liability due to the relocation into Alabama.

of the advantages for local economic activity that the Commerce Clause forbids.[6]

Thus, VFJ's claim that the ruling below is in conflict with this Court's decision in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), is entirely unfounded. First, as the Court emphasized, the North Carolina statute in *Fulton Corp.* "facially discriminate[d] against interstate commerce" by expressly "tax[ing] stock only to the degree that its issuing corporation participates in interstate commerce," *id.* at 333, whereas the Alabama subject-to-tax exception is facially neutral. Second, whereas the tax provision in *Fulton Corp.* had the practical effect of "tax[ing] a transaction or incident more heavily when it crosses state lines," Pet. 2 (quoting 516 U.S. at 331), and thus favored in-state economic activity, the Alabama statute challenged here has exactly the opposite

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[6] In the proceedings below, VFJ similarly argued that the subject-to-tax exception discriminated against the location of intangibles holding companies in states that employ combined unitary accounting or overseas. Before this Court, VFJ has apparently abandoned these arguments. In any case, the arguments fail for precisely the same reason, namely, that relocating a holding company from a combined unitary state, or from a foreign tax haven, to Alabama would actually increase, not decrease, the business's tax liabilities. In addition, as the Department argued below (and as the courts below recognized in the case of foreign locations, *see* Pet. App. 62a-63a), VFJ lacks standing to assert these arguments, since its holding companies are not located in a combined unitary state or abroad. Further, VFJ waived its combined-reporting argument by not raising it to the appellate court.

effect, imposing a heavier tax burden if the related intangibles holding company were to locate its activities within the state. Alabama's add-back statute, unlike the statute invalidated in *Fulton Corp.* simply does not "place burdens on the flow of commerce across its borders that commerce wholly within those borders would not bear." *Fulton Corp.*, 516 U.S. at 331 (quoting *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 180 (1995).[7]

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[7] Moreover, even if a court were to find that Alabama's add-back statute had a discriminatory effect, the question would remain whether the statute served "a legitimate local purpose that cannot be achieved through non-discriminatory means." *Fulton Corp.*, 516 U.S. at 344. Because the constitutional issues were never the primary focus in the litigation below and because there was never a finding of discriminatory effect, the Alabama courts did not have occasion to consider possible justifications for the statute's subject-to-tax exception. Were a court to reach this question, the Department would argue that the exception serves the important interest of avoiding any threat of multiple taxation of the same income; that, as with the use-tax credit for sales taxes already paid, which was approved by this Court in *Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937), the Alabama statute serves to ensure that income related to the use of intangibles is taxed once and only once; and, that the subject-to-tax exception therefore serves a legitimate and important state purpose.

B. THE DECISION BELOW PROPERLY APPLIED THIS COURT'S FAIR-APPORTIONMENT PRECEDENTS IN FINDING THAT THE APPLICATION OF ALABAMA'S STANDARD THREE-FACTOR APPORTIONMENT METHODOLOGY ENSURES THAT THE ADD-BACK STATUTE DOES NOT RESULT IN AN UNCONSTITUTIONAL APPORTIONMENT OF INCOME TO THE STATE.

VFJ's second asserted ground for review is its claim that the decision below conflicts with this Court's decisions requiring that states must fairly apportion taxes on income from interstate activities. VFJ argues that Alabama's determination of what portion of its income to tax impermissibly looks not to the taxpayer's activities in Alabama but to the tax policies of other states, and that the decision below conflicts with this Court's decision in *Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458 (2000). In fact, however, the decision below correctly stated and applied this Court's fair-apportionment standard, and properly distinguished *Hunt-Wesson*, a case which did not concern fair apportionment at all.

VFJ's fair-apportionment argument misses the mark so widely that it is hard to know how to respond.[8] The simple fact is that Alabama's add-back

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[8] The confusion is evidenced by the lack of correspondence between VFJ's second Question Presented, *see* Pet. at i (making

(Continued on following page)

statute, and its subject-to-tax exception, are unrelated to Alabama's apportionment methodology. On the contrary, the add-back provisions are applied in calculating a taxpayer's total income that is then subject to apportionment. The income calculated pursuant to the add-back statute is subsequently apportioned to Alabama by use of the standard three-factor formula, which considers the percentages of the taxpayer's payroll, property, and sales that are located in Alabama, a formula which this Court has characterized as "something of a benchmark against which other apportionment formulas are judged." *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 170 (1983).

Thus, VFJ simply is wrong when it asserts that Alabama's statute "attributes income to Alabama based not upon VFJ's conduct in Alabama, but instead upon the tax policy" of other states. Pet. 3. In fact, Alabama attributes income to Alabama based on the percentages of VFJ's payroll, property, and sales that are in Alabama. And, for the same reason, VFJ is equally mistaken when it argues that Alabama's apportionment methodology fails "on its face" to bear a rational relationship to the taxpayer's activity in the state. *Id.* at 23 (quoting *Norfolk & W. Ry. Co. v. Missouri State Tax Comm'n*, 390 U.S. 317, 325 (1968)).

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no reference to fair apportionment), and its associated argument heading and discussion, *see id.* at 20 (focusing on fair apportionment).

VFJ's claim that the decision below conflicts with this Court's decision in *Hunt-Wesson* fares no better. VFJ's characterization of *Hunt-Wesson* as a case about fair apportionment is thoroughly confused. *Hunt-Wesson* makes no mention whatsoever of apportionment, and is concerned instead with the question of whether the measure challenged there had the effect of taxing income that had no "'rational relationship' or 'nexus'" to the taxing state, *Hunt-Wesson*, 528 U.S. at 464, a question that relates to an entirely different prong of the Court's four-pronged approach to constitutional challenges to state taxes. *See Complete Auto*, 430 U.S. 274, 279 (1977).

In fact, the measure challenged in *Hunt-Wesson*, like Alabama's add-back statute, was concerned with the calculation of *pre*-apportionment, not *post*-apportionment, income, and in particular took the form of a denial of certain deductions that the taxpayer had utilized in calculating its federal taxable income. But the similarity between the cases ends there. The principle involved in *Hunt-Wesson* was that a state cannot tax income that is not connected with the unitary business that the taxpayer conducts in the state. *Hunt-Wesson*, 528 U.S. at 460 (a state "may not tax income received by a corporation from an unrelated business activity which constitutes a discrete business enterprise") (internal quotations omitted). The constitutional flaw in *Hunt-Wesson* was that the denial of the deduction there had the effect of imposing a tax on "nonunitary income" that bore no

"rational relationship or nexus" to the taxpayer's business in the taxing state. *Id.* at 464-65.

In sharp contrast, there is no suggestion in the present case that Alabama's add-back statute has the effect of reaching income unrelated to the taxpayer's activities in Alabama. As the Director of State Taxation for VF Corporation acknowledged at trial, there is no doubt that VFJ and its related intangibles holding companies are engaged in the same unitary business, Reporter's Transcript 147, as is evidenced by the very substantial "flow of value" between the operating company and the holding companies relating to the use of business trademarks. *See Container Corp.*, 463 U.S. at 178-79. Thus, there is no question that here, unlike in *Hunt-Wesson*, the income that is included in VFJ's income as a result of the denial of intangibles-expense deductions is income which has a substantial connection with the taxpayer's income-producing activities in Alabama.[9] Because there is no suggestion or possibility here that Alabama's add-back statute would have the effect of taxing income that is not part of the unitary business conducted by

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[9] Indeed, based on this close connection, a number of courts have found that states may impose taxes directly on the income of the intangibles holding companies, even if the only connection of the holding companies to the taxing states is their licensing of their intangibles for use by related companies doing business in the state. *See, e.g., Lanco, Inc. v. Director, Div'n of Tax'n*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S.Ct. 2974 (2007); *Geoffrey, Inc. v. South Carolina Dep't of Revenue and Taxation*, 437 S.E.2d 13 (S.Car. 1993), *cert. denied*, 114 S.Ct. 550 (1993).

the taxpayer in Alabama, *Hunt-Wesson* is entirely inapposite.[10]

Alabama's statute on its face apportions the taxpayer's income to the state by reference to familiar factors that "bear a rational relationship . . . to [the taxpayer's activities] connected with the taxing state," *Norfolk & W. Ry.*, 390 U.S. at 325, and there is no suggestion that the add-back statute results in taxation of any income from a non-unitary business activity unconnected with the state. Thus, the only remaining question concerning fair apportionment is whether Alabama's approach satisfies the requirement of "external consistency," *i.e.* whether it "reaches beyond that portion of value that is fairly attributable to economic activity with the taxing State."[11] *Jefferson Lines*, 514 U.S. at 185.

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[10] VFJ asserts that the Alabama courts, in characterizing deductions as "a matter of legislative grace," were ignoring the constitutional limitations imposed by *Hunt-Wesson*. *See* Pet. 24-25. But where such constitutional limitations are inapplicable, as in this case, the Alabama courts' acknowledgement of legislative authority over the granting and denial of deductions is entirely appropriate. Further, the courts' reference to the well-settled rule concerning deductions came, not in response to VFJ's fair-apportionment claim, but rather in response to VFJ's claim below that the add-back statute was a tax on the holding companies, a claim which VFJ has since abandoned. *See* Pet. App. 56a.

[11] It is undisputed in this case that the Alabama add-back statute satisfies the requirement of "internal consistency." So, that topic requires no discussion.

But, as the courts below correctly recognized, *see* Pet. App. 60a, the taxpayer, in challenging external consistency, bears the heavy burden of establishing "by clear and cogent evidence that the income attributed to the State is in fact out of all appropriate proportions to the business transacted in that State or has led to a grossly distorted result." *Container Corp.*, 463 U.S. at 170 (internal quotations and citations omitted). In the present case, VFJ made no attempt at trial to present evidence to meet this burden, and the courts below applied the proper standard and correctly concluded that "in this case, there has been no showing that the tax resulting from the application of Alabama's add-back statute was out of proportion to VFJ's activities in Alabama." Pet. App. 60a-61a. Nor could there be such a showing; in fact, Alabama's tax policy, like that of the twenty other states employing similar add-back statutes in conjunction with standard apportionment rules, provides a reasonable method for apportioning to Alabama a fair share of the income derived from VFJ's use of the trademarks licensed from its affiliated holding companies.

VFJ seeks to avoid this conclusion by introducing the novel argument that, by taking account of "the tax policy of a sister state" in determining the taxpayer's Alabama tax, the statute necessarily fails the external consistency standard. Pet. 23-24. Not only is this argument entirely devoid of any support in the decisions of this (or any other) Court, but it in fact directly contradicts the Court's holding in *Henneford*

v. Silas Mason Co., 300 U.S. 577 (1937), a case which remains a stable fixture in the Court's state-tax jurisprudence. *Silas Mason* upheld the constitutionality of Washington's use tax, and particularly of the provision that rendered the use tax inapplicable to the extent that the goods in question had been subjected to a sales tax either in Washington or some other state. *Id.* at 583-84. As with Alabama's add-back statute, the amount of use tax imposed by Washington depended directly on the tax policies of sister states; if goods were purchased in a state with a sales tax, then Washington did not impose its use tax, whereas if the state of purchase did not tax the sale, then Washington's use tax did apply. Yet, the Court found no constitutional objection to this aspect of Washington's tax scheme.[12] The novel principle that VFJ seeks to invoke would overrule this foundational element of the Court's state-tax case law.

Indeed, state tax systems routinely take account of the tax policies of sister states. Not only does every states' sales and use tax provisions include an exclusion like the one upheld in *Silas Mason*, *see All States Tax Guide* (RIA) ¶ 5485 (2009), but similarly, every states' personal income tax provisions allow resident

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[12] In upholding Washington's use-tax exclusion, the Court expressly distinguished the case of state price-fixing regulations that involve interstate comparisons and have the effect of projecting a state's regulation across state lines. 300 U.S. at 585-86. For the reasons articulated by Justice Cardozo there, VFJ's appeals to *Healy v. Beer Inst., Inc.*, 491 U.S. 324 (1989), another interstate price-fixing case, are equally inapposite here.

taxpayers a credit for any taxes paid on their income to other states. *See All States Tax Guide* (RIA) ¶ 236-A (2009); *see also* Del. Code Ann. Tit. 30, § 6407 (granting "headquarters management corporations" a credit against Delaware income tax for income tax paid "to any other state of the United States or the District of Columbia"). Thus, a taxpayer's income tax in his state of residence will typically vary depending on the tax policies of other states in which he earns income. In each of these cases, as in the case of Alabama's subject-to-tax exclusion, the effect of the measure is, in fact, to further one of the central purposes of the Court's fair-apportionment principle, namely, to avoid the threat of multiple taxation, *see Jefferson Lines*, 514 U.S. at 185, by adjusting one state's tax to take account of tax already paid elsewhere. VFJ's suggested novel principle would thus have the effect of impeding, not furthering, the purposes of fair apportionment.

A reversal of the decision below would create a direct conflict with *Silas Mason* and would raise serious doubts about the constitutionality of credits for sales or income tax paid to other states. A taxpayer could assert unconstitutionality against such a credit provision, if the taxpayer is not entitled to the credit (or is entitled to less of a credit) because the other state in which the taxpayer has some activity does not impose an income or sales tax (or imposes a tax that is less than some other state's tax). According to VFJ's contention, such a credit for tax paid to another state would unconstitutionally discriminate

among states according to whether those states impose an income or sales tax, "*i.e.*, whether they share Alabama's own tax policy." Pet. 18. According to VFJ, such a tax-credit provision would "classically 'Balkaniz[e]' the Nation's economy by setting its tax policy to have different effects on interstate commerce in some States, but not others." Pet. 18. Further, VFJ's contention would support a challenge to such a credit for tax paid to another state as "unconstitutional because it seeks to increase [a taxpayer's] taxable income based not on activity in Alabama, but on the tax policy of a sister State." Pet. 24.

VFJ's contentions as to the add-back statute's subject-to-tax exception are incorrect, as the courts below recognized and held. Moreover, if this Court were to reverse the decision below, well-settled law would be placed in doubt. Therefore, this Court should deny VFJ's petition.

II. IT WOULD BE WOEFULLY PREMATURE TO REVIEW THE ISSUES RAISED BY VFJ.

A. THE DECISION BELOW IS THE ONLY APPELLATE DECISION IN THE NATION ADDRESSING SUCH STATUTES.

Despite the fact that approximately twenty states and the District of Columbia have add-back statutes, the trial-court ruling below was the first court ruling in the nation that addressed the adding back of related-company royalty payments. And, the appellate decisions below still are the only such

appellate decisions in the nation, the obvious consequence of which is that there is no conflict to resolve among the states' highest courts. Therefore, this Court should wait for further analysis and development in the courts below, before involving itself in this subject matter.

B. THE ISSUES NOW RAISED BY VFJ WERE SEVERELY UNDERDEVELOPED BY VFJ BELOW. THEREFORE, THIS CASE DOES NOT CONSTITUTE A SUITABLE VEHICLE FOR DISCRETIONARY REVIEW.

Primarily, the case below involved VFJ's attempts to invoke two state-law, statutory exceptions to Alabama's add-back statute, *i.e.*, the subject-to-tax exception and the "unreasonableness" exception. VFJ paid little attention to the constitutional questions it now raises in its Petition. For example, VFJ's second argument to this Court – concerning fair apportionment – is not even identifiable in VFJ's Complaint.

The evidence at trial revolved around VFJ's claim that Lee and Wrangler had business purpose and economic substance, and therefore were not sham corporations. Pursuant to this claim, VFJ sought to invoke the "unreasonableness" exception, and the trial court so ruled without reaching any constitutional issues. The Department appealed.

In VFJ's 68-page brief to the Court of Civil Appeals, VFJ devoted a total of only four paragraphs to

constitutionality. That court reversed the trial court, deciding both of the statutory-exception questions against VFJ. Pet. App. 50a. The court also rejected VFJ's constitutional claims. Throughout its opinion, the Court of Civil Appeals acknowledged that VFJ did not challenge the Department's add-back calculation, and that VFJ did not present any evidence tending to show that the application of the add-back statute would result in VFJ's paying an amount of tax to Alabama that was disproportionate to VFJ's activities in Alabama. Pet. App. 29a-30a, 40a, and 60a-61a (quoting *Container Corp.*, *supra*, and *Jefferson Lines, supra*).

As to VFJ's discrimination argument, which consisted of three sentences, the court noted that VFJ cited only to authority discussing facially-discriminatory statutes. Pet. App. 61a-62a. Nevertheless, VFJ now criticizes the court's opinion because, according to VFJ, "it utterly ignores the discriminatory operation of Alabama's add-back regime." Pet. 16. VFJ's criticism is off the mark. The court fully and fairly responded to VFJ's cursory argument by noting that the exception "applies when the related member's income is taxed 'in Alabama *or any other state* of the United States,'" and by holding that "the application of Alabama's add-back statute does not benefit in-state corporations to the detriment of, or disproportionately to, out-of-state corporations." Pet. App. 62a.

The court cannot be faulted for failing to respond to arguments VFJ did not make, namely, that Alabama was "'project[ing]' its taxing policy 'into other

States,'" Pet. 18, or that Alabama was "disallow[ing] the deduction for royalty payments made to States outside Alabama that choose a different tax policy." Pet. 16. In fact, the court concluded its constitutional analysis by stating that "this court has addressed only those arguments VFJ has asserted in an effort to support the trial court's judgment in its favor. We decline to address any other arguments that might have been made regarding the alleged unconstitutionality of Alabama's add back statute." Pet. App. 63a-64a. The Alabama Supreme Court adopted the opinion of the Court of Civil Appeals as its own. Pet. App. 2a. Thus, the courts below never considered most of the specific constitutional arguments raised by VFJ before this Court.

The record below clearly demonstrates that this case does not present this Court with an "ideal vehicle," Pet. 30, nor a "comprehensive platform," Pet. 31, for review, as contended by VFJ. Instead, if this Court were to involve itself in an add-back case, it would be better served to do so where the arguments had been more fully fleshed out below.

VFJ cites to various commentators in its effort to convince this Court that there exists a pressing need for review. Pet. 28, 29. However, VFJ's commentators primarily are lawyers in private practice who represent taxpayers. In fact, one of the commentators cited by VFJ as "critiquing the decision below and contending that Alabama's add-back statute is unconstitutional"

actually appears before this Court as a representative of one of VFJ's *amici curiae*.[13] Discretionary review is not appropriate when a petitioner is reduced to essentially citing to itself as a reason for granting its petition.

Even some of VFJ's commentators acknowledge that the issues raised by VFJ are not mature for review. Specifically, VFJ quotes an article entitled *Surveying Constitutional Theories for Challenges to the Addback Statutes*, 35 State Tax Notes 613 (Feb. 28, 2005). Pet. 28 n. 8. The article's next sentence – the one that follows the sentence quoted by VFJ – is insightful: "A taxpayer bringing such a challenge must largely operate in uncharted territory. . . ." 35 State Tax Notes at 620-21. The authors subsequently refer to the type of add-back challenge mounted by VFJ as "blazing new ground." *Id.* at 622.

Operating in "uncharted territory" to "blaze new ground" is antithetical to the exercise of this Court's discretionary review, especially where the constitutional issues were underdeveloped below. Therefore, VFJ's Petition should be denied.

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[13] VFJ cites an article entitled *Addbacks Add Nothing to the Debate*, 48 State Tax Notes 1073 (June 30, 2008). Pet. 29 n. 9. The author of that article also appears as one of the counsel for the Institute for Professionals in Taxation, which filed an *amicus curiae* brief in support of VFJ.

III. VFJ'S PETITION DOES NOT PRESENT QUESTIONS OF PUBLIC OR "SURPASSING" IMPORTANCE.

A. THERE IS NO "CLOUD OF UNCERTAINTY" IN THE STATES' ADMINISTRATION OF ADD-BACK STATUTES.

VFJ contends that the decision below should be reviewed "now," because of what VFJ claims is a "cloud of uncertainty" hovering over the states' administration of add-back statutes. Pet. 29. Simply put, no such cloud exists. The fact that corporations who have employed the intangibles holding company device are displeased with an adverse decision does not mean that the administration of such statutes is uncertain. Instead, what is certain is that the financial stakes are high for those corporations. VFJ's "cloud of uncertainty" claim is an over-dramatization.

B. A REVERSAL IN THIS CASE WOULD NOT PROVIDE RELIEF TO VFJ OR TO OTHERS SIMILARLY SITUATED.

VFJ challenges only the subject-to-tax exception to Alabama's add-back statute. The court below correctly decided that VFJ failed to show that the exception has any constitutional defect. However, even if this Court were to reverse the decision below, the proper remedy would be to sever the exception, not to invalidate the entire add-back statute.

The legislation enacting the add-back statute specifically provided: "The provisions of this act are

severable. If any part of this act is declared invalid or unconstitutional, that declaration shall not affect the part which remains." Acts of Alabama 2001-1088, Section 9. If the exception were to be severed, the remainder of the add-back statute still would operate in a fair and reasonable manner, subjecting to Alabama tax only a fairly-apportioned share of the income shifted out of Alabama by use of the intangibles holding company device. Hence, the appropriate remedy for a finding of unconstitutionality would be to eliminate the source of the unconstitutionality, while allowing the rest of the legislative enactment to stand. *See King v. Campbell*, 988 So.2d 969, 981 (Ala. 2007) (stating that "[t]his Court is required to sever and save what can be saved in a statute in the event a portion of the statute is determined to be unconstitutional. *See* § 1-1-16, Ala. Code 1975.").

VFJ is incorrect when it states that Alabama requires "taxpayers to pay the tax (or pledge equivalent assets) before obtaining a meaningful opportunity to challenge the tax," citing "Ala. Code § 40-2A-9(g)(b)." Pet. 30. Instead, Alabama law allows a taxpayer the option of appealing an assessment of tax to either the Department's administrative law division ("ALD") or to circuit court. Ala. Code § 40-2A-7(b)(5)a and b. No payment or fee is required for a taxpayer to appeal to the ALD. Ala. Code § 40-2A-7(b)(5)a. Only if the appeal is to circuit court, must a

taxpayer first pay the tax at issue or post a bond or pledge assets. Ala. Code § 40-2A-7(b)(5)b.2.[14]

C. VFJ'S CONCERN FOR STATE COFFERS IS UNAVAILING.

VFJ presumes to speak on behalf of the states, suggesting, *e.g.*, that this Court save the "administrative costs" of future litigation, and asserting that a "prompt resolution" will benefit even those states that subsequently may consider adopting add-back statutes. Pet. 30. First, the states can fend for themselves in such matters, and Alabama is confident that there is no constitutional defect in its subject-to-tax exception. Second, the possibility of states saving future "administrative costs" falls far short of the standard for discretionary review set forth in Supreme Court Rule 10.

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[14] The subparagraph "§ 40-2A-9(g)(b)" cited by VFJ, Pet. 30, is non-existent. If VFJ was referring to a subparagraph within Ala. Code § 40-2A-9(g), that subsection addresses appeals to circuit court from a final order of the ALD, and does not address a taxpayer's initial appeal options contained in Ala. Code § 40-2A-7(b)(5)a and b. However, under Ala. Code § 40-2A-9(g), a taxpayer is required to pay the tax only if that taxpayer loses before the ALD.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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